CHAPTER

1

HOW DO WE COMPARE ECONOMIES?

As mankind approaches the end of the millennium, the twin crises of authoritarianism and socialist central planning have left only one competitor standing in the ring as an ideology of potentially universal validity: liberal democracy, the doctrine of individual freedom and popular sovereignty . . . In its economic manifestation, liberalism is the recognition of the right of free economic activity and economic exchange based on private property and markets.

Francis Fukuyama, The End of History and the Last Man

Introduction

We have witnessed a profound transformation of the world political and economic order, the ultimate outcome of which is impossible to foresee. The former Soviet Union (FSU) has broken up,[1] its empire of satellite states has dissolved, and most of the former constituent parts are trying to fulfill the above prophecy of Francis Fukuyama. In his view, the end of the Cold War means the convergence of the entire world on the American model of political economy and the end of any significant competition between alternative forms of political or economic systems.

Is this true? We beg to differ. For one thing the economic crisis of the former Soviet empire has spilled into the advanced capitalist world, partly through the conduit of reunified Germany, which drained money from its

[1]Prior to 1917 the Russian Empire included many nationalities ruled by a tsar. With the Bolshevik Revolution, several nationalities gained independence, some permanently like the Finns and the Poles, and some only briefly like the Ukrainians. Then there was Soviet Russia. In 1922 it became the Union of Soviet Socialist Republics (USSR) or Soviet Union, which ceased to exist at the end of 1991. Now there is a loose confederation of 12 of the former 15 republics of the USSR called the Commonwealth of Independent States (CIS). When referring in the present to all of the 15 republics as a group we shall use the term "former Soviet Union" or FSU.

neighbors to pay for the costs of unification. Unpopular incumbent governments and serious questions about economic policy resound throughout the supposedly victorious market capitalist nations.

Furthermore, the collapse of Soviet Communism has coincided with a surge of missionary activity in the formerly Soviet Central Asian republics by advocates of fundamentalist Islam. They present their view as not just a change in personal moral codes, but a total system of economic and political organization of society, a possible "third way" between capitalism and socialism. Throughout the Islamic world fundamentalist groups either have taken control of governments or are the leading opposition to existing governments. In other nations, movements based upon fundamentalist versions of local religions have emerged and become prominent. In East Asia many see the cultural heritage of Confucianism creating a special economic environment. This appeal to economic systems based on traditional religions is the *new traditional economy* and it presents a serious alternative on the world stage. The Islamic version is the most fully worked out and influential.

Fukuyama recognizes that the rise of Islamic fundamentalism constitutes a potential exception to his thesis, but responds that it will be limited to the zone of existing Islamic predominance, thus ruling it out as a "potentially universal ideology." But the emergence of similar movements in other religions offers the possibility that the new traditional economy concept could be universal even while differing in significant details across religions. Cold War could give way to Holy War.

Even if Fukuyama is right that the socialist alternative will shortly be dead and that fundamentalism will be limited in its appeal, economic tensions between the United States, Japan, and Western Europe have focused attention upon deep structural differences between these and other market capitalist economies. There are many varieties of market capitalism, and as stagnation and increasing income inequality threaten the world economy the significance of these differences increases and the global search for efficient and humane economic systems accelerates. Many countries have sought to emulate some aspects of the Japanese economic system, but even Japan is now experiencing considerable economic and political difficulties.

Indeed the socialist alternative continues both as an existing system and as a possibility in some form as yet unseen. The purest existence of classical socialism persists in relatively obscure corners of the globe such as North Korea and Cuba. But despite general dismantling of central planning bureaucracies, legalization of market activities, and privatization drives, large portions of the former Soviet bloc remain actually socialist in the sense of widespread state ownership of the means of production. In the most populous nation on earth, China, a grand drama unfolds as the system remains officially socialist while engaging in a piecemeal marketization and spread of capitalism.

Furthermore, even though Yugoslavia has collapsed both as a nation and as a system in a horribly tragic way, the idea of workers' management that its economy imperfectly represented persists and may have a new lease on life in the form of workers' ownership. This takes a variety of forms, from the profit-sharing "share economy,"[2] through classic cooperatives, to employee stock ownership plans (ESOPs), all of which exist in the United States and other market capitalist economies and are popular in the privatization efforts of many Eastern European countries.

This systemic turmoil coincides with the intense conflict between the "urge to merge," the push for integration of the world economy and its subparts in trade and policy, and the "drive to divide," the push for independence and isolation by increasingly small entities. Also continuing are the deep problems of the less developed countries, many of the poorest of which are in states of outright economic decline as they search for appropriate systems in this changing environment. These difficulties are further exacerbated by a global stagnation of economic growth that aggravates the systemic crises many economies are experiencing.

Thus the study of comparative economics has never been more important. The subject itself is undergoing transformation, just as its objects of study undergo transformation.

Criteria for Classifying Economies

Allocation Mechanisms

All economies must answer the questions of "what, how, and for whom" goods and services are produced. Fundamentally, economies produce and distribute goods and services among members of their societies. Production involves allocating factor inputs between different goods and services and distribution involves allocating produced goods and services among people.

There are three basic kinds of allocation mechanisms: *tradition, market,* and *command.* In a *traditional economy* allocation decisions depend on custom, what has been done in the past. Usually such customs or traditions will be associated with a broader social context defined by a dominant religion. Economic decision making becomes embedded in the broader social context.[3]

An example is the caste system associated with Hinduism in India. Technically illegal since India's independence from Great Britain in 1947, the caste system still dominates both social and economic structures in much of the nation, especially rural areas. The caste system constitutes a system of allocating labor—what one does is what one's parents did, not unlike under European feudalism. Each caste has an economic activity and is self-reproducing in that there is a very strong social inhibition against marrying outside one's caste. At the top are the Brahmins, the priestly caste; at the bottom are the

[2]See Martin Weitzman, *The Share Economy* (Cambridge: Harvard University Press, 1984).
[3]Karl Polanyi, *The Great Transformation* (Boston: Beacon Press, 1944).

Untouchables who gather dung for fuel and perform other unpleasant functions. Hinduism justifies this hierarchy through the doctrine of karma and reincarnation. When one dies, the caste into which one will be reborn is determined by one's karma, one's accumulated account of past good and evil behaviors. Thus everyone is where they deserve to be.

In a *market economy* allocation decisions are made by individuals or firms on the basis of price signals emanating from the interaction of supply and demand. These signals generally reveal themselves as individuals or firms engage in exchanging money for factor inputs or goods or services. That such a system can be very efficient is eloquently argued by Adam Smith in his 1776 *Wealth of Nations.* Every economy ever observed has at least some exchange activity, including tightly controlled command economies such as North Korea and very simple traditional economies such as that of the hunter-gatherer Khoi-San of the Kalahari desert in southern Africa. What marks a market economy is that a *majority* of economic decisions are made according to market forces rather than tradition or command.

In a *command economy* the most important allocation decisions are made by government authorities and are imposed by law or by force. Command economies were the last of the three forms to emerge historically—they rose with ancient empires such as Sumer and Egypt, which were the first strong and extended states wielding absolute power over crucial economic decision making. There is good reason to believe that the other two forms long predated the command economies of these empires, which date back a mere 5,000 years.

Forms of Ownership

Karl Marx and Friedrich Engels in the 1848 *Communist Manifesto* argue that the key to understanding an economy is to know who owns the means of production. Ownership determines the distinction between *capitalism* and *socialism,* defined in strictly economic terms. In capitalist economies land and produced means of production (the capital stock) are owned by private individuals or groups of private individuals organized as firms. In socialist economies the state owns the land and the capital stock.

This explanation is overly simplistic. There are a variety of intermediate forms and cases such as cooperatives or worker ownership. Generally such forms are viewed as still being capitalism although some argue that they constitute "true socialism."

It makes a big difference under socialism if ownership is predominantly by the central government or by local governments. The former is more likely to be associated with command decision making, whereas the latter may coincide with market-based decision making. An example of the latter is China where there has been a tremendous expansion of firms owned by local units of government that operate in the market economy independently of central authority in Beijing.

A third possibility is ownership by organized religious groups. In parts of Western Europe between 1000 and 1500 nearly one third of the land was owned by the Roman Catholic Church, with major technical innovations being made in abbeys, economically self-sufficient religious communities. In Iran after 1979 under the Islamic Republic, formerly privately owned businesses were seized by religious authorities and remain under their control, if not their formal "ownership."

Generally the concepts of "property" and "ownership" vary enormously from society to society. These distinctions arise not only from local traditions and practices but from legal rules and definitions as argued by institutionalist economists.[4]

Considering the division between capitalism and socialism raises the question of the ownership system's relationship to allocative mechanisms. We often see economies that are largely capitalist, like the one in the United States, also being largely market-oriented. We have also seen the most prominent examples of socialism, notably the USSR, also being command-oriented. This leads us to describe two extreme categories: *market capitalism* and *command socialism.*

But this simple dichotomization raises the possibility of "cross forms," namely *market socialism* and *command capitalism.* Although less common than the previous two, both have existed.

The classic example of *market socialism*[5] was Yugoslavia. The state owned the capital stock (land was privately owned) but allocative decisions were made by worker-managed firms within a market framework. The collapse of Yugoslavia has raised questions regarding the long-run viability of this particular hybrid, although China is doing well with its peculiar form of market socialism.

Yugoslavia's collapse and the rush towards market capitalism by most of Eastern Europe can be argued to confirm the argument of the Austrian economist, Ludwig von Mises,[6] that rational market calculation is only possible with capitalism because of the need for the profit motive to drive private property-owning decision makers to optimize and generate efficient price signals. However Yugoslavia's collapse may be due to regional and religious conflicts rather than economic failure.

The classic example of *command capitalism* was Nazi Germany. Although the proper name of the Nazi party was the National Socialist Party, Adolf

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[4]John R. Commons, *The Legal Foundations of Capitalism* (Madison: University of Wisconsin Press, 1931).

[5]Variations on this term include *socialist market economy* used by the Chinese to describe their system of market socialism and *social market economy* used by the Germans to describe their essentially market capitalist economy marked by extensive income redistribution and welfare programs.

[6]Ludwig von Mises, "Economic Calculation in Socialism," in *Comparative Economic Systems: Models and Cases,* 7th ed., ed. M. Bornstein (Burr Ridge: Irwin, pp. 273–79), originally published in expanded form in 1922.

Hitler avoided nationalizing such privately owned corporations as Krupp and I.G. Farben. Nevertheless these industries produced what his economic planners commanded. Similar systems appear temporarily in wartime in market capitalist economies, as in the United States during World War II when no private cars were produced in response to government orders, although the automobile industry remained privately owned.

An important point to understand is that there are no pure examples of any type of system. *All* real economies are mixed economies exhibiting elements of various allocation and ownership systems, even if they can be categorized one way or another.

The Role of Planning

Many comparative economists emphasize the contrast of "market versus plan" as a central defining characteristic of economic systems rather than our choice of tradition versus market versus command. Planning deals with *coordination* in an economy. In a centrally planned economy, *planners' preferences* dominate allocative decision making, whereas in a market economy *consumers' sovereignty* dominates allocative decision making.

There is a strong correlation between allocation decisions following a central plan and the general presence of command socialism, as in the USSR and most of its empire. But this correlation misses the crucial point, that planners' preferences determine allocative decision making *only* within a command framework. It is command that rules out consumers' sovereignty.

It is possible to have command without planning. An example is Soviet Russia during the period of War Communism (1917–1921) immediately after the Bolshevik Revolution, when civil war was compounded by invasion by foreign troops. Production followed commands from the center, but in a "shock" pattern whereby commands for production of certain goods were made when goods viewed as critical to the war effort became in short supply. A pattern resulted of higgledy-piggledy dashing from producing one "deficit" good to another with little effort to consider the impact of each decision or to coordinate such decisions. There was no time to plan or to even set up a planning mechanism.[7]

It is possible to have central planning coincide with market capitalism, the "planned market economy." Such planning is known as *indicative planning* because it lacks the command element. Examples of indicative planning have been France and Japan, although such planning is less influential than in the past.

Even in thoroughly market capitalist economies there is planning by specific government agencies involved in infrastructure investment such as transportation networks, functions that in most economies seem to be in the public

[7]The process of "planning how to plan" has been labeled *planification* by French planners and economists.

sector. For such cases even the very pro-market capitalist magazine *The Economist*[8] argues in a lead editorial that there is a strong case for planning if carried out intelligently and if accompanied by the use of market mechanisms such as congestion tolls on highways to ensure efficient use of the resulting infrastructure.

Types of Incentives

Economies vary according to the incentive schemes that motivate people to work and produce. The most common incentive scheme is *material,* paying people according to their productivity. In market capitalism this involves paying them their marginal product which maximizes profits for competitive firms hiring labor in such a system.

Material incentives under market capitalism also take the form of rewards for entrepreneurship and capital investment as economic profits and for savings as interest. In theory socialism rejects the former while, also in theory, Islam rejects the latter. Both socialism and Islam generally see material incentives as significant in motivating labor.[9]

An alternative that has been sometimes advocated and less frequently tried is *moral incentives,* trying to motivate work effort by appealing to some higher collective goal. Efforts to implement moral incentives occurred in China under Mao during the Great Proletarian Cultural Revolution from 1966 to 1976 and during certain periods in Cuba under Castro. The Chinese effort followed the slogan "serve the people." The record from both China and Cuba is that these periods generated serious stagnation of output.

But before dismissing moral incentives, note that they have been used temporarily when market capitalist economies have gone into a command mode during wartime. Thus production surged in the United States during World War II despite the imposition of wage and price controls limiting the material gains from hard work. Part of the motivation to work came from the wartime appeal to patriotic national sacrifice.

Also the new traditional economy depends partly on appealing to moral incentives. Islam and most great world religions do not completely deny the pay-for-work principle that undergirds material incentives. But they also see limits to this principle, both from the need for charity to the poor and from the general argument that excessive concentration on material goods is distracting from spiritual matters.

Income Redistribution and Social Safety Nets

Economies vary based on the extent to which and the methods by which governments intervene to redistribute income. This partly depends on how unequal income is to begin with before any redistributive policies are implemented.

[8] *The Economist,* "The Case for Central Planning," September 12, 1992.

[9] That socialism has not always successfully implemented material incentives for workers is shown by the old Soviet joke that "they pretend to pay us and we pretend to work."

Thus the Japanese government does much less redistributing than those of many other capitalist countries because Japan has a more equal distribution of wages than most other capitalist countries. Command socialist economies also have had less income redistribution because governments initially control the distribution of income through setting wages and forbidding capital or land income.

People differ greatly about the appropriate goal of income redistribution, much less the method. The Austrian economist and follower of von Mises, Friedrich A. Hayek, argues that the only just income distribution reflects a free market outcome in a context of well-defined property rights and complete equality of opportunity for all individuals. This suggests an ideal in which no government income redistribution results in generally greater inequality than is observed in most economies.

Sharply contrasting is the view of John Rawls[10] that the justness of a society is to be judged by how well off its worst-off individual is, the *maximin criterion.* He argues that selfish and rational individuals would support such a criterion if they fully understood the uncertainty of the future and that there is always the possibility that "there but for the grace of God go I." This suggests substantial redistribution towards absolute equality, limited only by disincentive effects becoming so great that the worst-off individual's income drops.

Rawls's view echoes that of many traditional religions. None insist on absolute equality of income, but most place an emphasis on charity and taking care of the poor. Although organized religions may court the wealthy for their possible financial support, there is a vein of contempt towards wealth as exemplified by the remark of Jesus that "It is easier for a camel to pass through the eye of a needle than it is for a rich man to enter heaven."

In his *Critique of the Gotha Program,* Karl Marx enunciated the ideal goal of *pure communism* as being "from each according to his ability, to each according to his need." This does not imply complete equality of income as people have different needs, for example due to different family sizes or health problems. Marx contrasted this goal with that of socialism, which would be "from each according to his ability, to each according to his work."

Clouding this entire discussion is the *equity-efficiency tradeoff,*[11] which states that greater efforts to make income more equal will result in less efficiency, meaning less growth. The argument is that material incentives are what draw forth productive and entrepreneurial effort. Thus vigorous efforts to redistribute income reduce the rewards for work and entrepreneurship and thus reduce the rate of economic growth. Such arguments are influential in many countries towards scaling back redistributive programs. This view has its most vigorous advocates among "supply-side" economists associated with the "Reagan Revolution" in the United States.

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[10]John Rawls, *A Theory of Justice* (Oxford: Clarendon, 1972).

[11]Arthur M. Okun, "Rewards in a Market Economy," in *Comparative Economic Systems: Models and Cases,* 7th ed., ed. M. Bornstein (Burr Ridge: Irwin, 1994), pp. 71–77.

Most societies struggle with intermediate approaches of one sort or another, although very poor countries generally cannot afford to do much redistributing as there is not much to redistribute. Most carry out some redistribution through their tax codes and through some sort of *social safety net* for certain categories of people: the aged, the unemployed, single mothers with children, the sick, and sometimes others as well. In advanced capitalist countries aging populations and medical care costs that are rising faster than the rate of inflation are putting tremendous fiscal pressure on social safety nets.

Generally in the command socialist economies a wider array of activities and people have been protected by social safety nets, although sometimes the quality of that protection has been questionable as in the case of Soviet medical care. A major problem of the current transition period with substantial economic declines occurring in the former Soviet bloc has been the partial dismantling and weakening of these safety nets.

A final point regarding the equity-efficiency trade-off is that *it is frequently false.* Some of the most rapidly growing economies in the world have reasonably equal distributions of income, such as the East Asian Newly Industrializing Countries (NICs), whereas some of the countries with very unequal income distributions have had poor growth records, such as El Salvador. It is crucial that income and wealth inequalities arise from differences in productivity and entrepreneurship rather than from corruption or inheritance. If inequality is perceived as unfair then the result may well be strikes, guerrilla war, or revolution, none of which are conducive to economic growth.[12]

The Role of Politics and Ideology

The relationship between politics and economics is subject to deep debate. Until nearly 100 years ago no distinction was made between the two disciplines, there being only *political economy.* Many still think that is how the subjects should be analyzed and that they cannot be realistically separated. At the heart of the linkage is ideology, in which certain political and economic systems are linked in distinct packages and given labels such as *communism* and *liberal democracy.*[13]

A central controversy has been whether or not political democracy is indissolubly linked with market capitalism and command socialism with dictatorship. Friedrich Hayek forcefully argues this position in his 1944 *The Road*

[12]This problem plagues the former Soviet bloc economies in their transition efforts in that many new entrepreneurs are either former Communist Party officials with special privileges or former black marketeers whose sources of initial finance are viewed as illegitimate by most people.

[13]This use of *liberal* is the classical or European usage, meaning individual freedom and minimal government. The modern American usage, meaning support for government intervention in the economy, arose in the 20th century from the evolution of the British Liberal party towards such a position from its earlier classical position.

to Serfdom, in which he claims that welfare state redistribution inevitably leads to command socialist dictatorship. Milton Friedman supports this view in his *Capitalism and Freedom.* Friedman argues that even if expanded government activity does not lead to full-blown dictatorship, it constitutes a reduction in the freedom of the individual to choose what to do with his or her income because of higher taxes. Such views are labeled *libertarian* and have deep roots in American and British thought. The view that there should be minimal government economic intervention is called *laissez-faire,* a French term from the mid-1700s literally meaning "let them do it," *them* being businesspeople.

Both Hayek and Friedman associate socialism with dictatorship and lack of individual freedom. Complete socialism reduces economic freedom insofar as private ownership of capital and land is forbidden. The old Soviet bloc was characterized by both economic socialism and political dictatorship. These countries are now generally moving towards both market capitalism and democracy.

But in Western Europe Social Democratic political parties exist that call themselves "socialist"[14] but that support neither extensive nationalization of the means of production nor political dictatorship. They support income redistribution and extensive social safety nets, although even in their heartland in northwestern Europe such approaches are under retreat. Nevertheless we have seen over 60 years of such social democracy in Sweden without the Hayekian prediction of political dictatorship coming true.

The split in Europe between socialist and communist political movements occurred after the 1917 Bolshevik Revolution in Russia when Lenin imposed a *dictatorship of the proletariat* under the leadership of a "vanguard party," later combined with a command socialist economy by Joseph Stalin. Although many Western European socialist parties continued to support nationalization and central planning for a long time, they opposed dictatorship.

Ironically, the ideological father of communism, Karl Marx, claimed that communism entailed the *withering away of the state.* The dictatorship of the proletariat was to be a strictly temporary phenomenon. Well aware of this, the Soviet Communists never claimed to have achieved communism, always labeling their own system *socialist* rather than *communist.*

The key libertarian claim that full-blown economic socialism has never coexisted with political democracy is true. But in some Western European countries democratic governments have carried out substantial nationalizations without going to dictatorship. Although absolutely forbidding private enterprise is incompatible with political democracy and personal freedom, having a great portion of the economy nationalized is not.

A further complication is that market capitalism has coexisted with authoritarian political regimes in parts of East Asia and Latin America. Many of

[14]A recent development has been some of the former Communist parties of Eastern Europe taking this name. Thus in Germany there is the old Social Democratic Party, while the former Communists are now the "Party of Democratic Socialism."

these countries have recently experienced a trend towards democracy. Nevertheless market capitalism is no guarantee of political democracy even if it is historically correlated with it.

Another competing ideology is new traditionalism, especially Islamic fundamentalism. The focus in Islamic fundamentalism is less on either politics or economics as an end, but on religion and its rules. The basic demand of the Islamic fundamentalists is the imposition of an Islamic law code, a Shari'a.[15] These codes address many issues from social matters such as restrictions on women's behavior to economic matters such as forbidding the charging of interest. But there is no definitive position on capitalism versus socialism. Nor is there a political theory of Islam other than the basic demand that a Shari'a be implemented and obeyed. It does not matter whether the enforcer of the law is a king, a mullah, a military dictator, or a democratically elected president. Indeed the current Islamic Republic of Iran is a functioning parliamentary democracy. But it is not a *liberal* democracy because individual rights and freedoms are subordinated to a Shari'a and the will of religious authorities.

Thus every generalization seems subject to exceptions rendering it almost unusable. But, although liberal democracies have adopted the command mode of allocative decision making on a temporary basis during wartime, none has done so on a permanent basis during peacetime. Here is a more definitive hypothesis: Permanent command control of an economy implies unequivocal loss of personal freedom because none can be allowed to challenge the system of such control. Thus it is permanent command that is incompatible with liberal democracy, not economic socialism.

Criteria for Evaluating Economies

Morris Bornstein[16] presents nine criteria by which the relative performance of economic systems can be compared.

First is the level of output. This figure should be corrected for population and the price level, giving us real per capita output as the measure which equals real per capita income. Despite difficulties in making cross-country comparisons because of differences in data gathering this is probably the best measure of the material standard of living in a society available to us. The highest levels of real per capita income exist in market capitalist economies.

Second is the growth rate of output. This figure must be corrected for population growth. It is often easier for middle to low income countries to grow faster than either the very poorest or the very richest. The very poorest often are caught in "low level equilibrium traps" where no investment can

[15] There is more than one such code. See Chapter 5.

[16] "The Comparison of Economic Systems: An Integration," in *Comparative Economic Systems: Models and Cases*, 7th ed., ed. M. Bornstein (Burr Ridge: Irwin, 1994).

occur because all output is absorbed by consumption in an effort merely to stay alive. The middle to low income countries that have escaped from such traps can borrow technology from the most advanced countries and play "catch-up" according to the *relative backwardness hypothesis*.[17] Such borrowing can bring dramatic productivity improvements in an economy that is more "relatively backward" compared to the world's leading economies. The growth of the richest countries is limited by the general advance of technology at the frontier of knowledge. Command socialist economies have sometimes grown quite rapidly for extended periods of time, but they suffer from a tendency towards serious stagnation in the longer run.

Third is the composition of output. The most notable variables of composition are the breakdown between consumption and investment, the share of military output, and public versus private goods. Command socialist economies generally have higher shares going to investment, although the East Asian market economies, such as Japan, also have high rates of investment.

Fourth is static efficiency. Formally this means Pareto optimality, that no one in society can be made better off without making someone else worse off. In this situation resources are being fully utilized to their best potential given the existing technology and as much is being produced as can be produced. Static efficiency implies that the labor force is fully employed and that the composition of goods being produced is what people want. It is widely argued that market economies are more successful in this area, although relative success is rather difficult to measure, and market economies tend to have worse unemployment than command economies.

Fifth is intertemporal or dynamic efficiency, which involves the allocation of resources over time to maximize long-run sustainable growth. An example of nonsustainable output maximization was the effort by the USSR to pump large amounts of oil in short periods of time. This push led to depletion of pressure in the wells, making it difficult to impossible to get out remaining oil later that could have been accessible. Long-run sustainability of growth ultimately depends on maintaining a viable environment, and it is now seen that failure to do so was an important factor in bringing about the fall of the Soviet bloc command socialisms.

Sixth is macroeconomic stability, the lack of large oscillations of output, employment, or the overall price level. It is usually argued that strict command economies achieve greater short-run macroeconomic stability, although there have been some spectacular exceptions.

Seventh is economic security of the individual in terms of income, employment, and related matters such as health care. This criterion is partially related to the previous one, but it also depends on the broader social safety nets of an economy.

[17]Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge: Harvard University Press, 1962).

Eighth is the degree of equity of the income and wealth distributions. Generally the socialist and social market economies have more equal distributions than the strictly market capitalist economies.

Ninth is the degree of freedom available to the individual in terms of work, consumption, property, investment, and more broadly in the civil and political realms. This last variable is difficult to quantify, but market economies are well ahead of command economies in this area.

Indeed, many of the items listed above are difficult to quantify. Nevertheless a summary of indexes of some of these criteria is presented in the tables below. Table 1–1 focuses on overall indicators, including per capita GNP, an index of real per capita GNP, annual growth rate of real per capita GNP, annual rate of inflation, share of gross private investment in GNP, the quintile ratio (the ratio of the share of national income going to the top fifth of the population to that of the bottom fifth of the population), and life expectancy at birth. Table 1–2 focuses on the role of government, including the shares of GNP going to central government consumption; defense spending; spending on health; and spending on housing, welfare, and social security (aggregated). It also covers the share of national income collected in taxes.

Data for many countries are extremely unreliable. This is true throughout the less developed countries, which do not have enough money for gathering data. For most of the former and current socialist countries the unreliability of data is notorious due to past propagandistic lying as well as corruption, although some problems with data arose from bureaucratic tendencies to excessive secrecy. Even officials in these countries could not get accurate data.[18] We have seen massive revisions of data for many of these countries recently.

Figure 1–1 presents a depiction of income distributions in several countries using Lorenz curves. These curves are constructed by assuming that a country's population is ranked according to income and distributed along the horizontal axis. The vertical axis then indicates the percentage of total national income going to a group of the population. The degree of inequality is indicated by the degree of curvature with more equal income distributions generating Lorenz curves closer to the 45 degree line. The ranking of the countries shown corresponds to their ranking according to quintile ratios as listed above.

The Lorenz curve can be used to generate another measure of income distribution which will be used frequently throughout this book. This measure is the Gini coefficient. It is the area between the Lorenz curve and the 45 degree line divided by the area below the 45 degree line. Thus Gini coefficients can range from zero to one with higher ones indicating a greater degree of inequality.

[18]Many top think tanks of the USSR used data on their own economy estimated by the U.S. Central Intelligence Agency (CIA) in the belief that it was the best available, although after the collapse of the USSR there was criticism in the U.S. Congress of the accuracy of those estimates.

TABLE 1–1 General Condition/Performance of Various Economies

Country	Per Capita GNP ($)	Real Index	Growth Rate	Inflation Rate	Investment Share	Quintile Ratio	Life Expectancy
			Market Capitalist				
Switzerland (a)	36,080	95.6	1.4	3.8	24	8.6	78
United States (a)	23,240	100.0	1.7	3.9	16	8.9	77
Australia (a)	17,260	75.0	1.6	6.4	20	9.6	77
Botswana* (a)	2,790	22.4	6.1	12.6	42	16.3	68
Colombia (a)	1,330	24.9	1.4	25.0	18	15.5	69
Indonesia (a)	670	12.8	4.0	8.4	35	4.9	60
Niger (a)	280	3.2	−4.3	1.7	5	n.a.	46
			Planned Market Capitalist				
Japan (a)	28,190	87.2	3.6	1.5	31	4.3	79
France (a)	22,260	83.0	1.7	5.4	20	7.4	77
S. Korea (a)	6,790	38.7	8.5	5.9	37	5.7	71
India (a)	310	5.2	3.1	8.5	23	4.7	61
			Social Market Capitalist				
Sweden (a)	27,010	76.2	1.5	7.2	17	4.6	78
W. Germany (a)	23,030	89.1	2.4	2.7	21	5.8	76
Netherlands (a)	20,480	76.0	1.7	1.7	21	4.5	77
Costa Rica (a)	1,960	24.0	0.8	22.5	28	12.7	76
Sri Lanka (a)	540	12.2	2.6	11.0	23	4.4	72
			Market Socialist				
Yugoslavia (b)	3,060	23.8	2.9	122.9	21	7.0	72
Hungary (a)	2,970	24.8	0.2	11.7	19	3.2	69
Egypt (a)	640	15.9	1.8	13.2	18	n.a.	62
China (a)	470	9.1	7.6	6.5	39	6.5	69
			Command Socialist				
USSR (c)	2,540	26.9	0.9	2.1	37	4.1	69
Romania (a)	1,130	11.9	−1.1	13.1	31	n.a.	70
Laos (a)	250	8.3	n.a.	n.a.	12	n.a.	51
Ethiopia (a)	110	1.5	−1.9	2.8	9	4.8	49
			New Traditional				
Iran (a)	2,200	22.8	−1.4	16.2	33	n.a.	65
Pakistan (a)	420	9.2	3.1	7.1	21	4.7	59

*Botswana has a substantial state-owned sector, to the point that it can be viewed as borderline market socialist. See Box 19.1. Investment share figure for Botswana is for 1970.

Note: For countries labeled *a* all data is from *World Development Report* of the World Bank, New York: Oxford, 1994. Per capita GNP figures are in 1992 U.S. dollars for 1992. The real per capita income indexes are for 1992 from the United Nations International Comparison Program (ICP), which accounts for differences in costs of living across countries as well as for exchange rates and are percents of the U.S. figure. GNP growth rates reflect the first column measure and are annual averages for 1980–92. Inflation rates are annual averages for 1980–92 of GDP deflators. Investment shares in GDP are for 1992, except for South Korea, China, and Laos for which they are for 1990 from the 1992 *World Development Report.*

Quintile ratios are derived from data from numerous sources, the Report noting the especial unreliability of these data. The years and data are: Switzerland, 1982 household income; United States, 1985 household income; Great Britain, 1988 household income; Botswana, 1985–86 household expenditures; Colombia, 1991 per capita income; Indonesia, 1987 per capita expenditures; Japan, 1979 household income; France, 1979 household income; South Korea, 1988 household income; India, 1989–90 per capita expenditures; Sweden, 1981 household income; West Germany, 1988 household income; Costa Rica, 1989 per capita income; Sri Lanka, 1990 per capita expenditures; Hungary, 1989 per capita income; Pakistan, 1991 per capita expenditures. Life expectancy is at birth for 1992.

For Yugoslavia, labeled *b*, all data are from the 1992 version of the source for *a* and are for the former Yugoslavia prior to its dissolution in 1991, and are for the year 1990 except that GNP per capita growth rate is for 1965–90, the inflation rate is for 1980–90, the quintile ratio is for 1987 for per capita income, and life expectancy is for 1990.

For the USSR, labeled *c*, per capita GNP and the per capita income quintile ratio are derived from ruble estimates for 1989 from Anthony B. Atkinson and John Micklewright. *Economic Transformation in Eastern Europe and the Distribution of Income* (New York: Cambridge University Press, 1992). The growth rate of per capita GNP and the CPI inflation rate are for 1980–85 after adjustment for population growth and the investment share in GNP is adjusted for population growth and the investment share in GNP is for 1988 from the United States CIA *Handbook of Economic Statistics* (Washington: USGPO, 1989). PPP-adjusted real index and life expectancy are from the 1994 *World Development Report* for 1992 for the Russian Federation (PPP figure for 1987 was 38.7). All other figures are for the USSR prior to its 1991 dissolution.

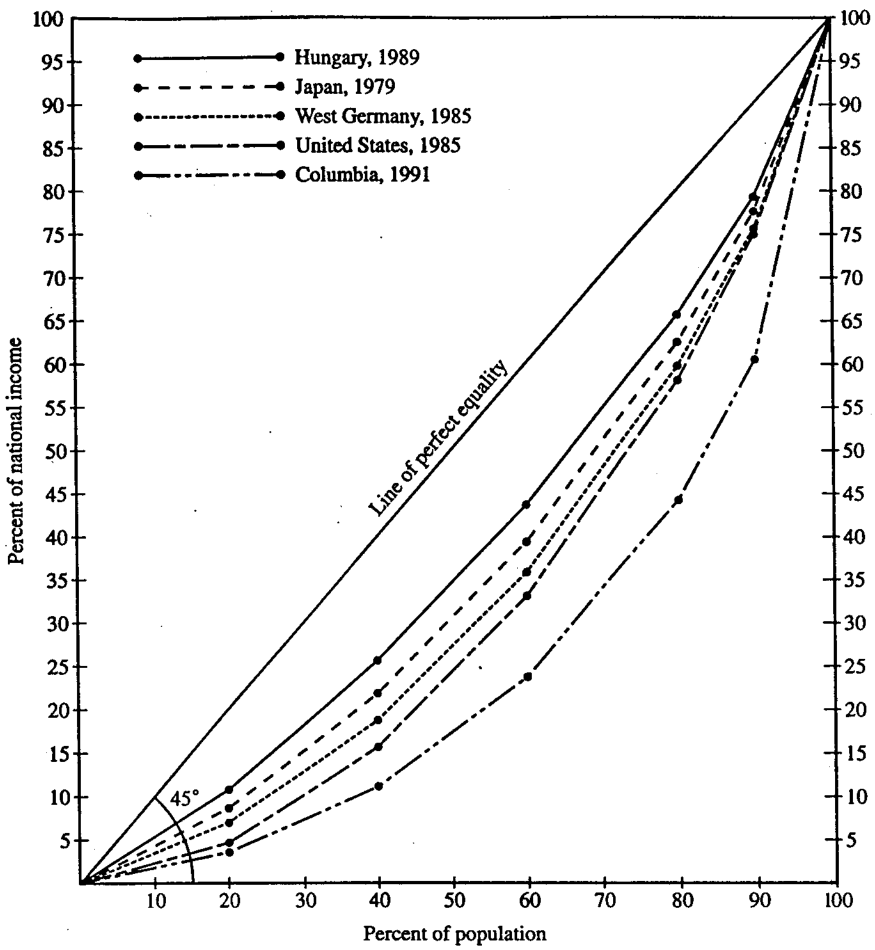
TABLE 1–2 Role of Government in Various Economies

Country	*% Government Expenditure*	*% Defense*	*% Health*	*% Housing Welfare Social Security*	*% Taxes*
		Market Capitalist			
Switzerland (*b*)	19.5	2.0	2.3	9.6	17.5
United States (*a*)	24.3	5.0	3.9	7.6	17.8
Australia (*a*)	27.4	2.4	3.5	8.5	24.9
Botswana (*a*)	40.4	5.4	1.9	5.6	30.6
Colombia (*b*)	13.5	0.9	0.5	2.9	10.4
Indonesia (*a*)	19.2	1.3	0.5	0.4	18.1
Niger (*b*)	18.7	0.7	0.8	0.7	12.4
		Planned Market Capitalist			
Japan (*c*)	15.8	1.1	n.a.	3.0	13.7
France (*a*)	45.0	2.9	7.2	20.3	38.0
S. Korea (*a*)	17.6	3.9	0.2	2.2	16.4
India (*a*)	16.8	2.5	0.3	1.0	11.1
		Social Market Capitalist			
Sweden (*a*)	47.5	2.6	0.4	26.7	37.8
W. Germany (*b*)	30.3	2.8	5.8	15.0	27.6
Netherlands (*a*)	52.8	2.4	7.3	21.6	45.3
Costa Rica (*a*)	25.5	0.0	8.2	3.4	20.8
Sri Lanka (*a*)	28.2	2.4	1.4	4.5	18.1
		Market Socialist			
Yugoslavia (*d*)	5.2	2.8	n.a.	0.3	5.4
Hungary (*a*)	54.7	2.0	4.3	19.3	47.0
Egypt (*b*)	53.7	6.1	1.3	7.0	30.8
China	n.a.	n.a.	n.a.	n.a.	n.a.
		Command Socialist			
USSR	n.a.	n.a.	n.a.	n.a.	n.a.
Romania (*a*)	41.7	4.3	3.8	11.1	20.9
Laos	n.a.	n.a.	n.a.	n.a.	n.a.
Ethiopia (*b*)	23.4	2.2	0.9	1.3	15.8
		New Traditional			
Iran (*a*)	19.7	2.0	1.5	3.9	7.7
Pakistan (*a*)	21.7	6.0	0.2	0.7	12.2

Note: Caveats regarding these figures include that only central government spending and taxes are reported, which understates the role of government in such strong local government countries as Switzerland and Yugoslavia; that military spending numbers are especially unreliable; and that some countries, especially Botswana and Iran, have major nontax government revenue sources.

Source: Data for countries labeled *a* are for 1992 and are derived from the 1994 World Bank *World Development Report*, except for countries labeled *b* for which data are for 1980. For Japan, *c*, sectoral breakdowns of spending are for 1988 from Takatoshi Ito, *The Japanese Economy* (Cambridge: MIT Press, 1992). Yugoslav, *d*, data are for 1990 from the 1992 *World Development Report* for the former Yugoslavia prior to its 1991 dissolution.

FIGURE 1–1 Lorenz Curves



Source: *World Development Report 1994*, World Bank, Table 30.

The numbers presented in Tables 1–1 and 1–2 are broadly consistent with the generalizations made earlier despite various anomalies and odd cases. Some of these may be due to data imperfections, but certainly not all of them. A close examination of these numbers should emphasize the uniqueness of each economy and the difficulty of attempting to classify economies into neatly defined categories. There is ultimately a degree of arbitrariness to such a procedure.

Summary and Conclusions

Fukuyama argues that the world economy is converging on American-style market capitalism. But this is a very complex process in a troubled and transforming world economy. In comparing economies central issues are the allocation system-tradition, market, or command—and the ownership system—capitalist or socialist. Economies vary in their income redistribution approaches, as well as their political systems and ideologies. Bornstein presents nine criteria for evaluating outcomes of economies and we provide data related to these criteria for 26 countries—both for general performance indicators and for the role of government in their economies.

Although many of the data are consistent with our expectations for the economic systems identified for the respective economies, numerous anomalies exist. Thus there are many other elements besides those listed in this chapter that are important to the functioning of an economy and its essential nature. A short list includes the nature of its openness to international trade and investment, its industrial organization, its policies with respect to the environment, the sectoral breakdown of its industries, its degrees of literacy and urbanization, its population density, and the broader cultural attitudes of its people, among others. Many of these will be discussed later in the individual country studies.

Questions for Discussion

1. Why does Fukuyama think that we are at "the end of history" and how is his idea relevant to comparative economics?
2. Are market economies necessarily "capitalist" and are command economies necessarily "socialist"? Why or why not?
3. Even though the U.S. economy is probably the most modern and market capitalist–oriented economy in the world, it has elements of a traditional economy within it. What are some examples?
4. Is market capitalism necessary for freedom? Why or why not?
5. Distinguish between the Hayekian, Rawlsian, socialist, and pure communist views of how income should be distributed.
6. Considering Tables 1–1 and 1–2, what are some countries that exhibit characteristics or performances not in accord with the generalizations made in this chapter with regard to the systemic category into which they are placed? What are those characteristics or performances and how are they anomalous?